

Economic Outlook and Review

M&I Investment Management Corp.

Economic Momentum Builds in Q4

After a noticeable deceleration in the spring and summer, U.S. economic growth appears to have rebounded in the second half of 2011. In particular, Q4 GDP growth is on track to exceed 3.0%, which would be the best quarterly showing in an otherwise disappointing year. Even with a strong year-end finish, 2011 will go down as a year that grew only half as much as expected at its start. Recall that at the end of 2010, the economy's short-term prospects appeared upbeat, especially after the Obama-GOP tax deal and a backdrop of surging corporate profits. Perhaps not wanting to make the same mistake as last year, prognosticators are much more subdued in their estimates for 2012 GDP growth. Current forecasts place 2012 GDP growth in the 2-2.5% range, substantially lower than the 3-3.5% forecasts of one year ago.

Surprising Consumer Spending Strength

Although the unemployment rate has ticked down to 8.5%, not many would argue that consumer spending is poised to surge upward. Yet vehicle sales have rebounded recently, and overall consumer spending is growing at a rate that is seemingly unsustainable given lackluster income growth. The growing divergence between spending growth and income growth can only be explained by a declining savings rate or a material underestimation in the job growth statistics. Furthermore, consumer confidence numbers are closer to levels associated with recessions than they are to any newfound spending growth resiliency.

Other explanatory factors for consumer spending growth are declining debt burdens and increased credit availability. This can provide cash to fuel spending that is not traceable to income data. No doubt some pent-up demand for durable goods exists, and as usual, will lead in most economic recoveries.

Fiscal Austerity May Inhibit Near-Term Prosperity

The partisan debate in Congress over several fiscal measures represents one of the significant wildcards surrounding any 2012 economic predictions. Unless policymakers reach

agreement, reduced payroll tax rates and emergency unemployment insurance benefits enacted in 2011 will expire in 2012. Economists estimate that alone could subtract nearly 1% from GDP growth. Odds are that the expiration of these programs will not be allowed, but the risk remains significant given that the previously approved debt ceiling agreement calls for mandatory federal spending cuts beginning in 2013, coupled with rising personal marginal tax rates — not a recipe for robust economic growth.

Labor Market Signals Modest Growth

The recent improvement in the level of first-time unemployment claims portends a slightly higher level of expected monthly job gains. As it stands today, nonfarm payroll expansion is still barely enough to absorb the nation's growing labor force.

The Manpower Employment Outlook Survey showed slightly more businesses expect to add to payrolls in Q1 2012 than it did last year. Given that corporate earnings continue to grow at very respectable rates, companies would seem to be in a position to hire, if desired. However, it may be the case that businesses are reluctant to expand until after the 2012 election when the regulatory and tax climate may be more easily discerned.

One area of the economy responsible for a key role in the economic recovery thus far has been factory production. Factory surveys remain positive, and manufacturing businesses have momentum as we enter 2012. In the past, recoveries become more self-sustaining as long as businesses are willing to expand (including payroll) without being sure about future demand. This time around, businesses seem to be increasing profits by focusing more on cost containment, refurbishing and modernizing, rather than expansionary hiring practices.

Exports Growing at Diminishing Rates

Export growth has been responsible for more than its typical contribution to the economic recovery. The hopes for a continuation of expanded exports are fast receding due to the recent strength in the dollar. Of course, it doesn't help when Asian growth is slowing and European growth has already stopped. Exports may not be the driver of growth they once were, but we believe they should not be a drag, either. Marginal contributions to GDP growth should remain.

Financial Market Review *Fourth Quarter 2011*

Housing Market Makes Some Progress

Residential housing is still in the doldrums, but over the past year multifamily permits and construction activity has accelerated. Apartment rents have been rising for several quarters, and new supply has not been an inhibitor to this improvement.

Meanwhile, existing single-family home sales have been stuck in the mud for two years. We would expect that low mortgage rates, combined with rising employment and slowly diminishing foreclosure inventories, will begin the long-awaited healing process in the housing market.

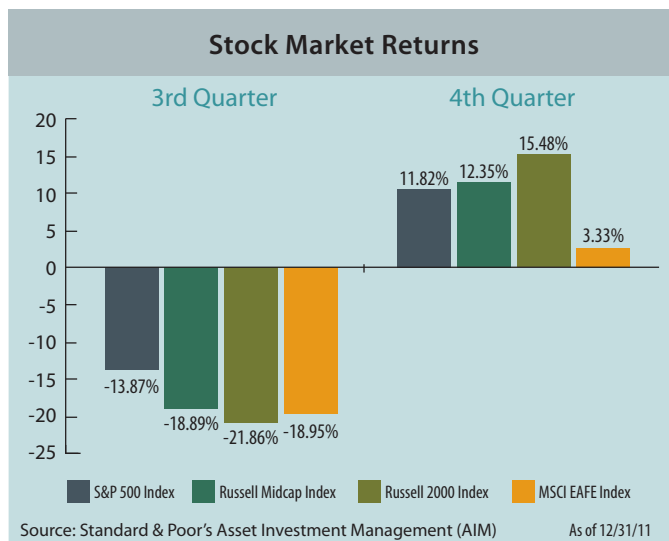
Happy New Year

It is unlikely our economy will grow robustly in 2012. However, there are many reasons to be optimistic that we can finally bury the talk of re-entering a recession. We withstood many shocks in 2011, a testament to the underlying resiliency of the U.S. economy. Monetary policy will remain extremely accommodative, while core inflation should remain under control. Lastly, maybe the mere political debate and rhetoric surrounding the election will be enough to spark some semblance of confidence in business owners to take the chance of hiring another worker on the margin. We need a renewed sense of spirit to reward those willing to take risk in order to ensure continued economic prosperity well into the future.

Stock Market Review

Despite a strong fourth quarter stock market rally, investors were happy to bid farewell to 2011. What started as a promising year with the S&P 500® showing an 8% gain by early April, quickly deteriorated into a grueling series of volatile market moves, finally ending the year right where we began. Returns for the year ended up inverse to the risk associated with the investment. In other words, large dividend paying stocks were the best performers, while small company stocks, foreign, and emerging market stocks all showed negative returns. The debt chaos in Europe was the single most destabilizing issue that investors dealt with during the year. Despite repeated attempts at resolving or at least stabilizing the crisis, we ended the year with much work left to be done. Large-cap stocks, as represented by the S&P 500 Index, rose 11.8% for the quarter and 2.1% year to date. Small- and mid-cap stocks, as represented by the Russell 2000® Index and the Russell Midcap® Index, gained 15.5% and 12.3% respectively for the quarter, but showed a negative 4.2% and 1.5% for the year. International stocks, as measured by the MSCI EAFE Index, rose a modest 3.3% for the quarter, but showed a negative 12.1% for the year. Part of the negative return can be attributed to a stronger U.S. dollar, but most of it was concern surrounding Europe.

We are all a little bit numb and weary of the endless drone of bad news. Stubborn unemployment, the lackluster housing market, European debt concerns, and a potential economic slowdown in China are real issues that could have a significant effect on our economic health. Yet, these are known concerns that are likely already discounted in markets as we begin the new year with record low Treasury yields and attractive stock valuations. Unfortunately, these concerns, especially Europe, have gone back and forth multiple times in the span of the past



12 months, causing sharp price movements on a monthly and sometimes daily basis. It is fair to say that market fatigue has set in for many. Nothing plays on investors' emotions more than sudden market declines, inviting a panic or sale at just the wrong time. A year like this, with the S&P repeatedly spiking up and down but ending virtually unchanged, invites very poor returns for an investor who sold stocks after one of the many sharp price corrections.

Fortunately, if you step away from the day-to-day volatility and news, there are positives. The United States has enjoyed steady, albeit moderate economic growth. Unemployment numbers appear to have bottomed and are slowly improving. Corporations have gone through a financial renaissance over the past few years, and are now sitting on \$2 trillion in cash. Strong corporate earnings growth has been building since 2009. For the year ended 2011, the aggregate S&P 500 earnings should come in at about \$97 per share, which computes to an attractive P/E ratio of 13. Assuming a conservative 5% earning advance in 2012, stocks look even less expensive at 12 times estimated earnings. Healthy corporate balance sheets are also paving the way for growing dividends. We start the year with large-cap stocks yielding about 2%, which is comparable to that currently available on 10-year Treasury notes. So why aren't stock prices higher? There continues to be a lack of confidence in the sustainability of the recovery and the painful memory of the financial crisis. Historically that also points to opportunity.

Unfortunately, the volatility that we experienced in 2011 is likely to continue. The trade-off for this volatility is the ability to purchase stocks at very reasonable valuations. The election will add another layer of uncertainty in 2012 at a time when many of the last year's issues are still pending. We do know, however, the stock market tends to discount recent events by incorporating various outcomes into current prices. For example, European stock prices may already reflect many of the financial challenges underway. For that reason, investors need to look beyond this short-term volatility and focus on their long-term goals. This goes back to targeting an appropriate asset allocation with a tolerable risk level, and ignoring the day-to-day negative news and price movements.

Fixed Income Market Review

The Treasury Bond Rally That Few Enjoyed

The Treasury bond market ended a spectacular year of performance with modest quarterly returns. Within the shorter end of the yield curve (as defined by bonds with maturities of three years or less), rate levels were basically unchanged for the quarter. Out longer, yields declined by up to 13 basis points. For the year, returns for Treasury securities were dominated by longer duration bonds. For example, the bellwether 10-year Treasury note ended 2011 with a total return of 17.2%, far outpacing most active bond managers who underestimated the ongoing flight to quality demand driven by continuing European financial uncertainty and turmoil. Paradoxically, the S&P rating cut for Treasury securities actually seemed to spur a further market rally as investors weighed U.S. bond market strength and liquidity favorably to less healthy sovereign debtors.

For bond investors trying to hide in short, high-quality parts of the bond market, results lagged behind in the performance race for the second consecutive year. Treasury bills returned a mere 14 basis points for the year, while asset-backed structures were ahead only 1.4%. Since the yield curve remained steep throughout 2011 and still remains so today, return opportunities in the short end of the Fed-induced yield curve will likely remain exceedingly low.

Municipal Bonds Outperform Every Major Asset Class in 2011

Municipal bond returns not only dominated the annual return comparison between all non-Treasury bond market sectors, performance also exceeded that of stocks and commodities. This outperformance contradicted what some market pundits foretold in early 2011 of skyrocketing bankruptcies that never came to fruition. The Barclays Municipal Bond Index was up a solid 2.1% in Q4 and 10.7% for the entire 2011 year.

Municipal defaults remain rare and have declined since 2009. Most defaults occur in peripheral areas of the market, especially for unrated bonds. In contrast, the improving state fiscal outlook in many areas should not be ignored. Revenue is generally coming in higher than conservative estimates, but has not yet recovered to pre-recession levels. States must continue to make tough choices, while facing federal funding cuts. Although we do not foresee a major surge in defaults for 2012, rating downgrades are still likely to exceed upgrades by a wide margin. Q3 2011 saw Moody's ratio of downgrades to upgrades move to 5.3, the highest since the financial crisis, but still accounting for less than 1% of the rated universe of credits.

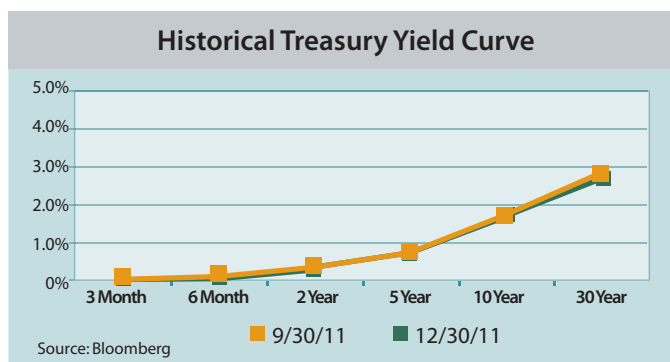
Corporate Bond Yields Dragged Lower by Declining Treasury Rates

Although the performance of investment-grade corporate bonds lagged those of Treasury securities for the year, investors generally enjoyed solid single-digit returns. The Barclays Corporate Bond Index produced a return of 8.2% for 2011. High-yield bonds were positive performers as well, but the return

of 5.0% for the Barclays U.S. Corporate High Yield Index shows riskier credits were laggards in comparison to higher-rated debt.

Bank and finance issues continued to perform poorly, but overall industrial and utility sectors performed very well. Overall yields on 10-year industrial bonds are generally 100 basis points lower than a year ago. Conversely, bank and finance bonds are now approximately 100 basis points higher in yield than comparably rated industrial or utility names.

We expect investors to continue to gravitate toward corporate bonds in 2012 as an alternative to fickle stock markets and low-yielding money market funds. From an issuer perspective, as long as rates stay low, corporate executives will likely continue to add debt to spur growth and return some capital to shareholders. While overall 2012 corporate loan issuance volume may remain close to 2011 levels, the use of bond proceeds may shift. Refinancing deals represented two-thirds of corporate issuance in 2011, a number expected to decline due to alternative funding needs for mergers and acquisitions, share buybacks and dividend increases.



Global Bonds Suffer From European Crisis

Despite relatively stable-to-improving fiscal health versus developed market issuers, emerging market bond performance was disappointing. Whenever the European crisis flared up, the rush to the quality and liquidity of Treasuries simply overwhelmed the secular improvement in the fundamental credit story unfolding in many emerging market economies. According to the Merrill Lynch Global Emerging Markets Sovereign & Credit Index, 2011 returns were limited to 3.9%.

2011 — A Tough Act to Follow

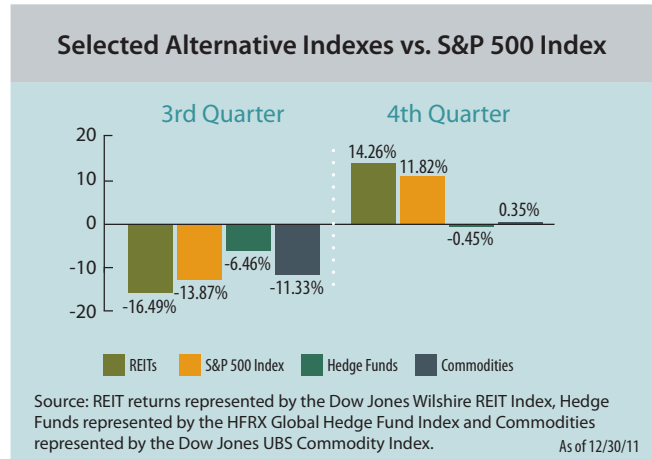
It is nearly a mathematical impossibility for longer-term Treasury bonds to repeat the performance of 2011. For that to happen, another financial meltdown of a magnitude exceeding the disaster experienced in 2008 would need to occur. Of course, if history lessons were learned properly, this needn't happen. A much more likely scenario is a U.S. economy that grows at a positive, albeit muted, pace. In that case, a year whereby a bond investor earns a return close to the coupon interest earned from a bond portfolio would not be farfetched. In fact, that would be a welcome outcome for those willing to take on a controlled amount of credit risk.

Alternatives

With a strong surge in the month of December, publicly traded REITs returned to positive territory and rewarded patient investors that had maintained their commitments to the asset class after the significant sell-off that occurred in the third quarter. Though most gains were achieved in the thinly traded holiday market conditions, the Wilshire U.S. REIT Index returned 5.4% in 2011, and outperformed all but the Dow Jones Industrials Average's 8.4% in 2011, after holding the top spot among equity benchmarks in 2010. The dividends paid by REITs accounted for half of the total return, and are indicative of the persistent demand for income-producing investments during this period of exceptionally low interest rates. Public REITs remain well below peak valuations of 2007 and relatively close to levels that preceded the credit crisis of 2008.

Returns for commodity investors disappointed further in the fourth quarter as gold broke through a 200-day moving average support level and sold down to \$1,550 per ounce. While gold remained positive on the year (+10%), its allure as a hedge to the euro and the dollar diminished as the European Central Bank put in place liquidity backstops for its member countries. The Dow Jones UBS Commodity Index lost 13.3% for the calendar year, as its weakness was attributed to weakening demand from emerging market consumers and manufacturers.

Though hedge fund managers struggled through much of 2011, their early year struggle was a precursor of the difficulties faced by equity and bond managers in the second half. Volatile trend reversals plagued performance in credit strategies, currency trading, commodities and ultimately stocks. Most managers employed portfolio hedges throughout the year by purchasing "put options" to guard against a sudden meltdown of the debt-ridden Euro Zone — only to have the hedges expire worthless as the S&P 500 had a negligible net change for 2011.



Private equity has been a bright spot in 2011. Investor capital has flowed into direct lending funds, and thereby supported fund valuations. Nevertheless, capital raising for venture and buyout funds has remained challenging, as many institutions have overcommitted to illiquid lock-up funds and are anxious to see realized returns and payouts.

Monthly Updates:

Readers are reminded that our detailed Monthly Economic Update & Market Review publication is available from our websites at mi-imc.com and bmo-fundsus.com.

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S&P 500 Index is an unmanaged index of large-cap common stocks. The Russell 2000 Index is an unmanaged index that measures the performance of the smallest 2000 U.S. companies in the Russell 3000 Index. The Russell Midcap Index measures the performance of the smallest 800 U.S. companies in the Russell 1000 Index. MSCI EAFE Index Europe, Australasia, and Far East Index (EAFE) is a standard unmanaged foreign securities index representing major non-U.S. stock markets, as monitored by Morgan Stanley Capital International. The Dow Jones U.S. Select REIT Index is comprised of U.S. companies whose charters are the equity ownership and operation of commercial real estate. The HFRX Global Hedge Fund Index is designed to measure the performance of the hedge fund universe. It is comprised of all eligible hedge fund strategies. The Dow Jones UBS Commodity Index is comprised of futures contracts of commodities traded on U.S. exchanges, with the exception of aluminum, nickel, and zinc. The index reflects the return on fully collateralized positions in the underlying commodity futures. Investments cannot be made in an index.

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